



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 5, 2002

MEMORANDUM FOR COMMISSIONER ROSSOTTI

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FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Office of Audit Comments Concerning Management's
Response to the Audit Report, *The Internal Revenue Service
Should Evaluate the Feasibility of Using Available Documents to
Verify Information Reported on Business Tax Returns*
(Audit # 200230001)

This memorandum presents our concerns with the Internal Revenue Service's (IRS) management response to the subject audit report. The response to the report was received after the final report was released.

We are concerned that the IRS plans no actions in response to our report. The data from our report, management's response, and the Office of Audit comments follow.

Recommendations for Which the IRS Plans No Corrective Actions

Recommendation Number 1: We recommended that the Director, Compliance, Small Business/Self-Employed (SB/SE) Division, evaluate all information documents the IRS receives for businesses to determine if they can be used to increase business tax compliance.

Management's Response: Management indicated that they would continue to explore ways to use information reported to the IRS. However, even if legislative changes were made, there are problems (outlined in detail in the response) that reduce the probability of implementing a business matching program.

Office of Audit Comment: Except for some limited uses, the IRS has not recently evaluated the different types of information documents to determine if they can be used to verify information reported on business tax returns. In July 2000, the IRS acknowledged in the SB/SE Division's "Strategy and Program Plans" that it has not taken advantage of information documents as a compliance tool for business taxpayers.

We are concerned that there are apparently no substantive activities, either ongoing or planned, that would accomplish this or resolve the issues raised in our report.

The IRS received 100 million information documents on businesses for Tax Year 2000 but does not know the total dollar value reported on them. Most of these documents are legally required to be filed. The IRS may be able to use the documents to identify many business taxpayers who are not compliant with the tax code, including those who do not report the proper income and deductions as well as those who have not filed. Since individual taxpayers have their income and other tax return items verified, it seems equitable that business taxpayers, to the extent possible, should also have their income and tax return items verified. We agree that the establishment of a business information document matching program could be difficult and that challenges to performing a direct match exist. However, as the General Accounting Office stated in its report entitled, *Benefits of a Corporate Document Matching Program Exceed the Costs* (Reference Number GAO/GGD-91-118, dated September 1991), these obstacles could be overcome, resulting in a profitable compliance initiative that increases taxpayer fairness.

We acknowledge the IRS' past actions to help create a business information document matching program, and we discussed many of these actions in our report. Most actions cited in the response were under the former IRS organizational structure. The new IRS structure, with four operating divisions that are organized around specialized groups of taxpayers, should now be better suited to use information documents in a variety of ways to increase business tax compliance.

Recommendation Number 2: The Director, Compliance, SB/SE Division, should, based on the evaluation of business information documents, consider the feasibility of legislative changes to require the filing of additional information documents for corporations, where applicable.

Management's Response: Management indicated that they would continue to identify and match the information the IRS is receiving. However, recognizing the fate of two legislative proposals (both initiated in the 1990s), they believe that a legislative request requiring corporations to report corporate-to-corporate income transactions is not feasible at this time.

Office of Audit's Comment: We acknowledge that the IRS has previously proposed legislative changes without success. However, we would envision that the legislative proposal would take place only after the completion of a comprehensive study of all the information documents the IRS receives for businesses. A relevant legislative proposal then could be formulated that would be effective at increasing business compliance while minimizing taxpayer burden.

The IRS' Tax Compliance Activity Report, dated April 2002, makes clear that those who comply with the tax law should have confidence that other taxpayers are also complying. In addition, the report states that there should be fair application of the tax law. The IRS has acknowledged that taxpayer compliance has been eroding over the years and that businesses are the largest part of the tax gap. A finely tuned legislative proposal could increase business compliance while addressing Congressional concerns.

Congressional action requiring financial institutions to more fully report corporate interest and dividends would enable the IRS to have a better compliance program. However, the IRS should not wait for Congressional action. The IRS needs to review the information documents it already receives to determine how they can be used to verify business tax returns.

While we still believe our recommendations are worthwhile, we do not intend to elevate our disagreement to the Department of the Treasury for resolution. Consequently, no further action on your part is required.

Copies of this memorandum are also being sent to the IRS managers who received a copy of the final report. Please contact me at (202) 622-3837 if you have questions.

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